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AUTOMATIC REGULATION OF MONOPOLY BY COMPETITIVE INVESTMENT

One of the two most prominent methods of dealing with monopoly is to break it up into smaller units which are then supposed to compete among themselves in the sale of their products, resulting in such reduction of the price of these products as will correspond with the cost of their investment. The other method is to fix a legal price at which a monopoly shall sell its products so that the consumer shall be required to pay only a reasonable return on the capital actually used in the business. Each of these methods is arbitrary in its action. Another plan is here presented, by which the required results may be achieved by virtually automatic action through the systematic application of well-known economic principles.

By means of a regulation which utilizes the fundamental principles that govern the somewhat irregular and uncertain action of exchange under competitive conditions, competition may be restored in a much more desirable form than hitherto and without destroying monopoly. This method I call regulation of monopoly by competitive investment.

Competitive investment, which is the underlying method of competitive monopoly, is built upon several important relations that exist between prices, profits, and security values. As a basis for price fixing it is assumed that the profits that can be realized by a monopoly depend directly upon the prices that can be secured for the product, and that the value of the securities which represent the ownership of the monopoly depends in the long run directly upon these profits in the same manner that the value of land depends upon the rent that it will yield. The normal competitive cost of the capital invested in an enterprise is assumed to be measured by the yield that must be offered or expected in order to induce the public to risk the investment of its money in such an enterprise; and the amount of this required yield or rate of profit on investment is assumed to be indicated by the relation between the actual dividends received in the present and expected in the future and the actual prices paid for the securities in the market.

But if this indicated required rate of profit or yield of securities were then applied to the market value of the securities in estimating the required dividend on investment, the process would only

work in a circle and operate in much the same manner as the interaction between security values and prices and earnings under conditions of monopoly. So it must be applied to a fixed value of the investment represented by the securities, this value being established once for all by the money actually sacrificed in building up the business or by appraisal or otherwise. The practical operation of this provision would be that the market value of the securities could never depart greatly from the established value of the investment which the securities represented. The earnings, however, would vary with all the requirements of the market, so that the price of the product would be determined at all times by the average rate of profit at which the public was willing to risk its money in the enterprise. Then, although an organization might constitute a complete monopoly, the price of its product would be really determined by competition of a much wider scope than could ever possibly exist in the competitive sale of its product. The rate of profit, and therefore the price, would be set by those who were willing to accept the least return on their investment in competition with every one who had money to invest in the business, instead of being fixed by those only who had an operating plant and other facilities necessary for the production of the commodity or who could purchase such a plant on equal terms and operate it without oversupplying the market.¹

According to the Supreme Court, a corporation is entitled to a "fair return on a fair value of its investment." Under the method of competitive investment the corporation virtually fixes the rate of return on its own securities by setting the price at which they are offered for sale in the open market in competition with the return at which the public is willing to furnish capital. And, instead of being established arbitrarily to correspond with supposed market conditions, the rate of return to be allowed in fixing prices is taken equal to the ratio of the estimated normal allowance for dividends expected in the future to the actual average market value of the securities during the preceding year. It may be shown that the operation of the method is such that the normal dividends actually received in the future will closely approximate this estimated normal allowance. However, this normal allowance

¹ Space will not permit an extended mathematical description which shows exactly how this method would work out in detail so only the most important requirements can be indicated. However, I shall be glad to submit, to any reader who may be interested, the detailed method which I have to suggest.

for dividends does not include gains resulting from reduced cost of production due to economy and efficiency, nor losses proceeding from neglect of economy and efficiency in production.

In order to prevent abnormal security values and, finally, abnormal prices from being caused by manipulation of the market, the security values used for computing the yearly average must be the lowest daily offering at which no sale was made. Then if the security-holders placed too high a value on their holdings so that no securities were sold, a low acceptable rate of return would be indicated, and this applied to the appraised value of the investment would establish a smaller allowance for dividends, and therefore a lower price for the products or services of the corporation. On the other hand, if the security-holder tried to get an excessive allowance for dividends by offering his holdings at too low a value he would risk the loss of some of his holdings by the acceptance of his offering, and in that case his low offer would not be counted after all. The average rate of return acceptable to the security-holder and the public being computed, it would then be applied to the appraised value of the investment to show how much should be added to operating costs for dividends in fixing the price for products or services.

But the gravest problem of economic engineering, perhaps, is to "secure that increase in economy and efficiency in production without which our multiplying millions dare not face the future." So the acid test of all proposed economic methods should show whether the incentive toward economy and efficiency is strengthened or weakened. Under competition or monopoly this supremely important condition is met in an uncertain and irregular manner. Under competition the hard-earned rewards of efficiency are likely to be lost as soon as a competitor learns the secret of the proposed processes or methods of management. On the other hand, when these improvements are protected by monopoly they are usually capitalized so that perpetual incomes are created for those who never earned them, and consumers are thus prevented from ever sharing in such improvements in the arts. And, finally, monopoly creates a condition under which attention to speculation and manipulation of securities pays the management of the corporation so much better that scant attention is given to economy and efficiency.

Under competitive monopoly, however, manipulation of securities would be futile, but security-holders would be protected in the

enjoyment of all the gains due to individual initiative and economy and efficiency in production for a definite term of years just as if they were awarded a patent right. This is done by taking the unit cost of operation to be used in price fixing as an average over a preceding term of years. Thus, averaging the unit cost over nine years is equivalent to allowing the security-holders a perfect monopoly of the total gain from all improvements for a period of five years. But even if such a monopoly were allowed for a much longer term, all unearned gains from the monopoly of natural resources would still be inhibited and the consumer would be infinitely better off than if the improvements in the arts were capitalized in perpetuity. Moreover, if the unearned gains from the monopoly of natural resources were cut off, perhaps more attention would be paid to securing the liberal rewards flowing from improvements in the processes of production.

Under complete competition, increased earnings due to economy in production could not cause a permanent increase in security values, because such values would always be limited by the returns that would be acceptable to competitors with new capital, who would adopt the improved methods. Then, since the method of competitive investment would prevent a permanent increase of security values except for actual investment while providing for increased earnings due to reduced operating costs, a way would thus be provided for separating all gains due to individual initiative and economy and efficiency in production from those due to special privilege and monopoly, and crediting such gains to manager, capitalist, or workman for any period of time that public interest might dictate.

Although the adjustments already indicated would provide fairly correct relations between producer and consumer, an exact adjustment may easily be provided by a system of virtual amortization between them of all surpluses and deficits that arise on account of the discrepancy between the actual normal return realized from the investment and the estimated return which was used in fixing prices. This would be done by adjusting the price so as to provide for earnings that would compensate for all unforeseen fluctuations that would have occurred and for deficits that usually arise in the early years of an undertaking. This would also guarantee the investor against loss in making needful and desirable improvements without allowing such losses to be capitalized so that they

would be paid for over and over by future generations of consumers forever.

One of the chief results to be accomplished by the method of competitive investment is the restoration of competition in its most desirable and effective form by shifting its basis back in the industrial process from the supply of product, where at best it is not entirely effective, to the supply of capital, where it more properly belongs. Since the market value of securities so regulated cannot depart much from the established value of the investment on which the required earnings are estimated and the rates or prices for the product are based, these prices are held down to a normal value in a much more effective manner than if monopolies were broken up into smaller supposedly competing units. Instead of the prices of products being held to correspond with the costs of investments by the indirect and uncertain effect of the competition of industrial units in the sale of products, the prices of products are held in a direct correspondence with the cost of investments by the competition in the supply of capital to the enterprise among the individuals who furnish it. These results are accomplished by competitive investment, because those in the market who are willing to furnish capital cheapest will make the highest offers for the securities of a corporation. The security-holders must then accept these offers or place a still higher quotation on their securities. But the higher the average quotation for the year, the lower will be the indicated rate of profit on investment which will be used in fixing the prices for the product in the succeeding year. In this way prices would actually be fixed by competition in the money market—a competition far more effective than competition in the commodity market, even among small units, could ever be.

One of the most serious fundamental objections to regulation that has ever been made is that “if regulation were to become general our base line for establishing a reasonable rate of earnings would disappear and our own standard of reasonable earnings would have to be made.” In arbitrary regulation the normal yield of securities similar to those subject to control has to be ascertained as closely as possible from market reports and applied to an estimated value of the investment in making up the estimated earnings from which the required prices of product can be calculated; therefore the data from other securities would naturally become meager and unsatisfactory if most all securities were subject to regula-

tion. Under the method of competitive investment, however, the normal return required by an average investor in a given security is ascertained entirely from conditions related to the security itself, whatever may be its actual and nominal values. This is done by computing the ratio of the annual earnings estimated to be available for dividends to the average market quotations of the securities for the year, taken under suitable conditions. By this means the basis of regulation is established automatically at its natural and proper value for the security under consideration, and is entirely independent of what the basis of regulation for any other security might be. So it is evident that in the case of automatic regulation by the method of competitive investment "our base line of regulation" could not disappear or become impaired even if regulation by this method became universal.

Under arbitrary regulation, a misjudgment in fixing the price of products at too high or too low a value will naturally result in giving the securities a fictitious value correspondingly higher or lower than the estimated value of the investment which was taken as a basis for price fixing. Too high a price is a burden on the consumer, leads to injudicious bond issues based on the fictitious valuation, and makes a future reduction in price practically impossible to carry out. Too low a price, on the other hand, leads to litigation on a plea of "confiscation of property," or perhaps to bankruptcy. But under automatic regulation it would be known that the surplus resulting from an excessive price one year would only be counted toward a corresponding reduction in price for the next year. Hence, this knowledge of the future would naturally prevent any one from offering much more for the securities than their normal value. It would also be known that a deficit arising from a deficient price would be counted toward a commensurate increase in price for the succeeding year; so this knowledge of compensating future returns would retain the confidence of the public in the securities and hold them up to their normal value during the period of meager earnings.

Thus the well-defined method of fixing prices under competitive investment would amount to a practical foreknowledge of future earnings that would establish a confidence in all of the securities of a corporation, which would virtually place them all upon a basis comparable with that held by the bonds of the corporation. Speculation and manipulation of such securities by insiders would

be of no avail, because the required publicity of accounts would tell the public as much about the future earnings of the company as its officials could know. The encouragement of investment in regulated industries would then be a vitally important effect of the restoration of confidence which would result from the knowledge that, as far as regulation could be effective, future prices would always provide the market rate of profit demanded by the public, for all money invested. Since the future earnings of regulated securities would be known with reasonable assurance, such securities could not be boosted in the market to a fictitious valuation, and therefore the shrinkage of the fictitious values of securities regulated by competitive investment could never be a cause of financial panics or business depression.

Under monopoly, extensions and betterments are immediately profitable when the average price of the product is high enough above the normal to keep the rate of the profit on the least profitable extension above the yield on investment that is demanded by the public. In this case, money borrowed at current rates will yield an increment of profit to the stockholders, although the average rate of return on the whole investment will be lessened on account of the diminishing marginal profit from the extensions. But at normal prices the profit on additional capital is likely to be temporarily below normal on account of the diminishing returns from the successive additions of capital to a business. This condition makes it very difficult, if not impossible, to finance extensions to existing plants when arbitrary regulation has brought the price of the product down near to what will only provide "a fair return on a fair value of the investment," because securities issued for supplying funds for building extensions and betterments can not be sold at such a price that the profits realized from these extensions and betterments themselves will pay the interest or yield the returns which the public demands on such securities. The deficit will then come out of the profits on the stock-securities, and although this might not reduce such profits below "a fair return on a fair value" of the *whole* investment, still it would turn out to be a losing transaction for the stockholders. Such being the case, they would naturally demand rates for service high enough above a "fair return on a fair value" of their whole investment to provide a "fair return" on all the extensions which were constructed.

Although a discounted excess of profits in the future would naturally compensate for present deficiencies, there is no guarantee

under arbitrary regulation that such excess profits would not be nullified by cutting down the rates in the future to provide only a "fair return on a fair value" of the future investment. Under automatic regulation, however, this condition can not occur, because the service rates are then controlled in such a way that a temporary deficit in the operation of a part of the service, when not due to an increase in the unit cost of production, does not affect the average rate of profit that is realized on any of the securities. Although extensions may not at once pay a profit as great as that demanded by the public on the money invested in them, service rates are automatically adjusted in such a way that all deficits in profits on investments in extensions are finally made up—if high enough special rates can ever be collected in the future to pay for such extensions, or if such extensions are made on the responsibility of the general public. Since the security of legitimate investments and the receipt of reasonable returns in the future would thus be almost guaranteed, the method of competitive investment applied to the railroad situation would provide means for making extensions and improvements in service by the sale of new securities at reasonable prices without an arbitrary increase in traffic rates. Under present conditions, increase in traffic rates may be applied only to increase dividends; and this results in an increase in the value of existing securities, which, in turn, is likely to bring back the former condition in perhaps a more aggravated form, calling just as insistently for another increase in rates.

The direct effect of competitive investment upon wages would not be very great, except that wages now depressed by monopoly could more easily be raised to normal, and wage disputes would be largely minimized because the automatic adjustment of prices would prevent the loss in profits due to a rise in wages from being permanent. By whatever amount present prices are now boosted above the normal by monopoly, however, the purchasing power of all wage and salaries would then be increased as soon as such prices were restored to normal by the automatic regulation of competitive investment. But, important as the results of the method of competitive investment would be in other respects, there is nothing to show that it would of itself greatly affect the causes of unemployment or provide an equal opportunity to earn a living.

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